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UNCLAS SECTION 01 OF 03 SAO PAULO 000236

SIPDIS
SENSITIVE

STATE PASS USTR FOR KDUCKWORTH
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZIL MOSTLY INSULATED FROM U.S. SLOWDOWN

SENSITIVE BUT UNCLASSIFIED--PLEAE TREAT ACCORDINGLY

REF: A. 07 Sao Paulo 086
¶B. Sao Paulo 227
¶C. Sao Paulo 130

¶1. (SBU) ummary: Brazil is more insulated from any U.S. drien worldwide economic slowdown than other emergin market countries. Its domestic economy fuels ecnomic growth, Brazilian banks have plenty of captal to lend, and Brazil is increasingly integrated into world markets. Similarly, the Brazilian stck exchange outperformed its emerging market peers, nearly doubling the gains of the next best emeging market performer. At a time when international markets are more risk averse, Brazil received the coveted investment grade foreign currency sovereign credit rating from Standard and Poor's. However, Brazil is not immune. There are some signs that access to international credit lines is more limited than before, and the impact of a U.S. slowdown on other countries, particularly on China, may have a measurable impact on Brazil. End Summary.

Lots of Padding

¶2. (SBU) Brazil's financial system is strong and has demonstrated a resiliency to the U.S. economic downturn that would not have been possible ten years ago. The Brazilian banking system is extremely well-capitalized. Indeed, Itau Securities CEO Roberto Nishikawa told Econoff that Brazilian banks have enough capital to avoid a similar credit crisis even with domestic credit expansion to a record level on the order of 40 percent of GDP this year. (Note: Henrique Meirelles, President of the Central Bank stated to Econoff on April 11 that he expected the credit growth to decrease from over 20 percent per year to approximately 10 to 15 percent growth in
¶2008. End Note.) Brazil's public sector has nearly retired its dollar-denominated debt, which was a source of trouble in earlier financial crises. Brazil in February became a net creditor, indicating that Brazil now holds more in reserves than it owes.

¶3. (SBU) Brazil's two stock exchanges, the Bovespa and the Commodities and Futures Exchange, merged to form the world's third largest stock exchange (ref A). The Bovespa outperformed its 15 emerging market peers between August 2007, when the U.S. sub-prime crisis first unraveled, and April of this year. (Note: The

Brazilian index Ibovespa gained 19 percent, beating out Russia which had 11 percent, and India and Mexico with six percent. The primary Chinese index has dropped 26 percent since August. End Note.)

¶4. (U) Brazil is now increasingly integrated into world markets, exporting a diverse range of products to hundreds of countries worldwide. For example, the GOB's export destinations by region in 2007 showed a balanced distribution between the four principal regions: the European Union (25 percent), Latin America and the Caribbean (22 percent), the U.S. (15 percent), and Asia (15 percent). Similarly, Brazilian exports span consumer goods, manufactured products, and agricultural products, and no one commodity dominates exports. Among Brazil's exports are several commodities including sugar, soy products, coffee, meats, and metals that have seen record prices in recent years. According to Sergio Werlang, Director of Credit at Banco Itau, commodity producer-countries are less vulnerable to an economic downturn as long as demand for commodities stays strong. Brazil will be less affected by the U.S. downturn because it should continue to prosper from high commodity prices.

¶5. (SBU) Even with soaring commodity prices, domestic demand drives the Brazilian economy, growing by 6.85 percentage points in 2007. By contrast, the external sector negatively contributed to GDP growth and drove overall GDP growth down to 5.4 percent last year. Director of Economic Research at Bradesco Bank, Octavio de Barros, told Econoffs that Bradesco expected about five percent GDP growth this year regardless of international conditions due to Brazil's strong domestic demand. He identified credit expansion (27 percent last year), real wage growth (two percent from March 2007 to March 2008), and the predictability of a stable economy when making investment decisions as keys driving this growth.

On the Margins?

¶6. (SBU) For the most part, the Brazilian financial system does not depend on external financing. Barros told Econoff that for approximately 70 percent of private investments last year, companies used their own resources, while 11 percent used domestic commercial banks and only two percent relied on external financing for their investments. Despite Brazil's independence, however, there are a few areas on the margins where less international credit availability, primarily from U.S. banks, may affect investments in Brazil. Carlos Bentancourt, CEO of Bracor Investments, told Econoff that the Bear Stearns collapse immediately hit the Brazilian credit market as banks cut international lines of credit. Betancourt noted, however, that he had not seen any change in Brazil's fundamentals that would merit a credit crunch. He pointed instead to contagion caused by the banks, likely to result in decreasing leverage and a move towards less risky debt. Press reports have also listed tightened international credit lines among the factors for the failures of a few large projects.

Inflation Bigger Concern

¶7. (U) Brazilian officials are more concerned about food price inflation than a global economic slowdown (ref B). Despite single digit inflation numbers over the last five years, the Central Bank took a forceful stand in April by raising interest rates by 0.5 percentage points amid fears that inflation would surpass the target of 4.5 percent. According to Luiz Fernando Figueiredo of Maua Investments, the investment community expects two more interest rate hikes of 0.5 percentage points each between now and July. There is little expectation that the current tightening cycle will result in rates rising more than 1.5 to two percentage points.

Investment on Track

¶8. (U) Despite the adjustment in monetary policy and a real interest rate of 7.1 percent (among the highest in the world), Barros told Econoff that Bradesco thinks interest rate hikes

probably will not significantly alter the private sector's investment decisions. Barros highlighted Bradesco's proprietary survey that queries 1,600 Brazilian companies whether interest rate hikes would affect their investment decisions. Approximately 60 percent of companies said that a one percent increase over the course of the year would not affect their investment decisions, and only 17 percent said it would moderately or heavily affect their decisions. With a two percent hike, 50 percent said it would not affect their decision and 27 percent said that it would. By comparison, the survey showed that 67 percent of respondents said that the global market turbulence and an eventual U.S. recession would not affect their investments over the next six months, and only five percent said it would have a marked impact on their middle-term horizon.

¶9. (U) On April 30, Standard and Poor's upgraded Brazil's sovereign credit rating to investment grade (septel). The upgrade opens the doors for further investment in Brazil, especially to funds limited to investment grade assets, and is likely to mitigate any investment slowdown because of interest rate hikes. Foreign direct investment (FDI) in Brazil last year was USD 34.6 billion and is at record levels already this year. According to the UN, Brazil ranks fifth among the most attractive countries for FDI, behind only China, India, the U.S., and Russia.

The China Factor

¶10. (U) While trade with the U.S. is declining, Brazilian trade flows with emerging markets are up from 35 percent of exports 20 years ago to 55 percent today, according to Octavio de Barros. Brazil's second largest trading partner, China, is a primary driver of this trend toward emerging markets. Brazilian exports to China last year were up 28 percent from 2006 and imports from China were

up were up 57 percent (ref C). Barros stated that Brazil's main risk of a global economic slowdown would be a secondary slowdown in China. Barros underscored, however, that Bradesco does not expect any deceleration because they believe domestic demand will continue to drive the Chinese economy. Barros pointed to several large infrastructure projects the Chinese government has planned, including building mass transit in all cities over one million people, which should drive demand especially for Brazilian commodities such as iron ore. Sergio Werlang told Econoff that Itau believes China is the key to determining whether there will be any measurable impact in Brazil from the U.S. downturn. He stated that the Chinese economy is larger every day and that Chinese growth is responsible for maintaining commodity prices. For these reasons, financial analysts in Sao Paulo have not ratcheted down their GDP growth forecasts for 2008. Merrill Lynch's forecast, for example, showed growth only slightly down from 4.6 percent to 4.5 percent after the April interest rate hike.

Comment

¶11. (SBU) Brazil's performance amid worldwide fears of a U.S. slowdown has been robust. Indeed, Standard and Poor's awarded Brazil with an investment grade sovereign credit rating for its good behavior. However, despite its resilience against a slowdown, Brazil is not invulnerable. Brazil's bigger challenge will be achieving higher potential GDP growth above five percent and keeping inflation at bay. End Comment.

¶12. (U) This cable has been cleared by Embassy Brasilia and coordinated with the US Treasury Financial Attache in Sao Paulo.

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